BEFORE THE ARIZONA CORPORATION COMMISSION

**COMMISSIONERS**

JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

IN THE MATTER OF THE APPLICATION OF ARIZONA PUBLIC SERVICE COMPANY FOR A HEARING TO DETERMINE THE FAIR VALUE OF THE UTILITY PROPERTY OF THE COMPANY FOR RATEMAKING PURPOSES, TO FIX A JUST AND REASONABLE RATE OF RETURN TEHREON, TO APROVE RATE SCHEDULES DESIGNED TO DEVELOP SUCH RETURN, AND FOR APPROVAL OF PURCHASED POWER CONTRACT.

Docket No. E-01345A-03-0437

**SETTLING PARTIES' EXCEPTIONS**

## I. INTRODUCTION.

The Parties to the Proposed Settlement Agreement hereby submit Exceptions to the Recommended Opinion and Order issued by Judge Farmer on February 28, 2005. The Parties appreciate Judge Farmer's efforts to timely issue a thorough and well-reasoned proposal. Nonetheless, the Parties respectfully submit the following Exceptions for two purposes: first, to clarify the proposed order's description of Rate E-32-TOU; and second, to suggest specific changes to the proposed order's treatment of the power supply adjustor ("PSA"). As described below, the Parties' suggested changes are consistent with both the Proposed Settlement Agreement and the evidentiary record supporting it.

The Parties request that the Commission approve the proposed order as clarified and modified by these Exceptions.

## II. THE RECOMMENDED ORDER'S LIMITATIONS ON THE PROPOSED PSA CONSTITUTE A MATERIAL CHANGE TO THE AGREEMENT AND POTENTIALLY COULD AFFECT APS OPERATIONS AND RESOURCE PROCUREMENT IN A MANNER HARMFUL TO CUSTOMERS AND TO THE DEVELOPMENT OF THE COMPETITIVE WHOLESALE MARKET.

The Recommended Order proposed a material change to the PSA mechanism agreed to by the Settling Parties and opposed by no party. Specifically, the Recommended Order places a "cap" on

recoverable natural gas costs of $500 million per year. This provision could potentially distort the Company's resource acquisition and utilization in a manner harmful to both customers and the development of a competitive wholesale market.

In addition, the Recommended Order makes certain statements about the Commission's ability to reconsider the PSA in future rate proceedings that appear to be inconsistent with the Proposed Settlement. The Settling Parties therefore believe that the Recommended Order's discussion of this issue should be amended to conform to the Proposed Settlement Agreement.

**A. $500 Million Cap on Natural Gas Cost Recovery**

The Recommended Order would "limit the amount of 'annual gas costs' that can be used to calculate the annual PSA to no more than $500,000,000 – as shown in Staff Exhibit 23." (Recommended Order at 16.) However, the Recommended Order does not clearly specify the precise costs that are to be included in the $500,000,000 cap. If the $500,000,000 cap is adopted, the Parties recommend that the Commission clarify that the costs to be included in it are only natural gas commodity costs utilized in APS' plants to serve retail customers. This would exclude gas utilized in "tolling" arrangements with merchant power plants, gas utilized in making off-system sales and gas from biomass projects.

In a tolling arrangement, APS provides gas to a merchant power facility that is selling its electric output to APS through a purchased power agreement ("PPA"). APS pays the merchant a lower price for such electric power to reflect the fact that APS is providing the gas. Such arrangements make sense for customers when APS can acquire gas cheaper than the merchant generator because of volume considerations (APS is a much bigger buyer of gas), stronger credit, or special gas market expertise. Without this proposed clarification, it is possible that APS would be denied recovery of these gas costs through the PSA while customers would benefit from the reduced price of purchased power. And to the extent tolling arrangements are discouraged altogether, there is an adverse impact on the competitive market because gas-fired generation would be less competitive with other forms of generation.

Gas used to produce off-system sales is not a cost to APS customers but a benefit. If such gas costs are to be included in any calculation of the PSA "cap" suggested by the Recommended Order,

they should be netted against the corresponding off-system sales revenues. Otherwise, you could have a situation where APS burns a dollar's worth of gas to generate $1.25 in revenues, but because the Company was at the "cap" for gas cost recovery, the dollar of additional gas cost would not be recoverable through the PSA, but APS customers would receive credit for the additional $1.25 of off-system sales revenue. This would be inequitable and would discourage APS from making otherwise economic (and beneficial to the APS retail customer) off-system sales. These off-system revenues from the sales in question should be subtracted or credited against gas costs included in the determination of any "cap" on PSA recovery.

Finally, the Commission has clearly indicated its desire to promote renewable energy, including the use of landfill and other forms of bio-gas generation. Including these sorts of gas costs within the cap would discourage APS' development of these sorts of non-traditional generation resources.

More fundamentally, the "cap" (irrespective of how calculated) was not suggested by any party to these proceedings. Such a cap undermines one of the primary purposes for including fuel as well as purchased power in the PSA, namely to remove any incentive for APS to make resource acquisition decisions based upon cost recovery rather than the economics of the resource. (Settlement Direct Testimony of Linda A. Jaress at 7-9). A cap on natural gas cost recovery could create an incentive for APS to favor purchased power as compared to self-generation or to favor non-gas fuels such as coal and oil. Finally, under the long-term resources RFP provided for in Section IX of the Proposed Settlement, APS is permitted to acquire merchant facilities and operate them as APS units. This was a critical aspect of this Section both to APS and to the merchant power community. (Settlement Direct Testimony of Donald G. Robinson at 15 and Settlement Direct Testimony of Greg Patterson at 5). Since virtually all the generation that is out there for APS to potentially acquire for the benefit of its customers is gas-fired, the Recommended Order's "cap" on natural gas cost recovery may influence APS to favor purchased power in the long-term resource procurement process and to disfavor the acquisition by APS of new gas-fired generation. The potential for APS to make resource acquisition decisions based upon the workings of an adjustment clause, instead of the economics underlying the resources, could create ongoing complications for the Commission's

review of the prudence of APS' actions. Finally, such actions by APS could not only adversely impact APS customers by removing a potentially economic resource to meet their needs, but could also impede development of a competitive wholesale market by removing one of the means by which a merchant power owner can either exit a market or reduce its presence. And it is axiomatic that the ease of both entry into and exit from markets is a prerequisite for efficient competition.

The Recommended Order appears to suggest that the proposed "cap" on natural gas cost recovery through the PSA should not be a big problem for APS because "there is no moratorium on filing a rate case." (Recommended Order at 16). While the fact that there is no moratorium on rate case filings tends to partially mitigate the impact of the cap on gas cost recovery through the PSA, it is at best a partial and inadequate solution. First, the processing of a rate case takes a significant period of time. The Commission's "time clock" rules contemplate rate proceedings for a Class A utility taking approximately thirteen (13) months for processing, assuming that the Application meets sufficiency requirements when initially filed. In addition, because rate cases are based on historical periods, a rate case order would necessarily leave a period in which changes in gas costs were not captured. Finally, as mentioned above, the availability of a rate case does not alter the existence of incentives to make resource acquisition decisions inappropriately based on fuel source rather than the economics of a resource.

The Settling Parties believe this limitation on the PSA to be material within the meaning of Paragraph 136. Thus, they urge the Commission to modify the Recommended Order by deleting the language in the last paragraph of page 16 running from line 15 through line 24. The remainder of that paragraph on page 17 would be correspondingly modified by removal of the word "[F]inally" on line one and removal of the last sentence of such paragraph. The paragraph in question would then read:

> We will not allow any fuel costs from 2005 that were incurred prior to the effective date of this Decision to be included in the calculation of the PSA implemented in 2006.

**B. Duration of the PSA**

The Proposed Settlement provides, as does the Recommended Order, that the Commission may re-examine the PSA as early as in the Company's next general rate proceeding (Paragraph 28).

The Proposed Settlement also allows the Commission to modify or abolish the PSA as a result of such rate proceeding. This is also consistent with the Recommended Order. However, the Proposed Settlement indicates that a decision by the Commission to abolish the PSA would not be effectively implemented until the full five-year trial period had been completed (Id.). It is on this point that the Recommended Order differs from the Proposed Settlement Agreement. For both the Company and customers (Tr. at 1249), the agreement on a trial period long enough for a fair evaluation of the impact of the PSA and for fuel prices to run through a full cycle (a cycle which is clearly on the upward swing in the short run) was a critical part of the negotiations. The Settling Parties suggest that the Commission should either add the words "upon conclusion of the 5-year period referenced in the Settlement Agreement" after the end of line 24 on page 16 of the Recommended Order, or alternatively delete the last sentence of text on that same page.

## III. THE RECOMMENDED ORDER FAILS TO ADDRESS THE INADVERTENT OMISSION IN APPENDIX J TO THE SETTLEMENT AGREEMENT FOR RATE E-32-TOU OF THE REDUCTION IN THE DELIVERY-RELATED DEMAND CHARGE FOR RESIDUAL OFF-PEAK DEMAND AFTER THE FIRST 100 KW OF CUSTOMER PEAK DEMAND.

In their settlement testimony, both AECC and APS point out that there was an inadvertent omission in Appendix J to the Settlement Agreement for Rate E-32-TOU. These parties explain that the delivery-related demand charge for Rate E-32-TOU should be reduced after the first 100 kW of load for residual off-peak demand, just as is done in the standard E-32 rate. This reduction was inadvertently omitted from Appendix J. Instead of remaining at the initial level of $7.722 per kW-month, after the first 100 kW of demand, the unbundled residual off-peak demand charge for delivery at Secondary voltage should be reduced to $3.497, exactly as occurs for on-peak hours. The amount of this reduction should also be reflected in the bundled rate. After the first 100 kW of demand, the unbundled residual off-peak demand charge for delivery at Primary voltage should be reduced to $2.877, exactly as occurs for on-peak hours, with the amount of this reduction also reflected in the bundled rate. Moreover, the initial rate block for residual off-peak delivery will only apply to the first 100 kW of *combined* on-peak and residual off-peak load. None of the other parties disagreed with this clarification, but it was inadvertently omitted in the Recommended Order's discussion of the Proposed Settlement's rate design. The Commission should likewise accept this clarification of

Appendix J and direct that in its compliance filing, APS shall modify Rate E-32-TOU in accordance with these changes.

The Settling Parties urge the Commission to add the following language to the Recommended Order at page 28, line 7, following the word "customers":

> Testimony was offered at the hearing that there was an inadvertent omission in Appendix J to the Settlement Agreement for Rate E-32-TOU in that the delivery-related demand charge for Rate E-32-TOU should have been reduced after the first 100 kW of demand for residual off-peak demand[1] and that the initial rate block for residual off-peak delivery should be applied only to the first 100 kW of combined on-peak and residual off-peak demand. We will, therefore, direct APS to modify Rate E-32-TOU in accordance with these changes in its compliance filing.

RESPECTFULLY SUBMITTED this 14th day of March, 2005.

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On Behalf of All Settling Parties

[1] Instead of remaining at the initial level of $7.722 per kW-month, after the first 100 kW of demand, the unbundled residual off-peak demand charge for delivery at Secondary voltage will be reduced to $3.497; after the first 100 kW of demand, the unbundled residual off-peak demand charge for delivery at Primary voltage will be reduced to $2.877, with both of these changes incorporated into the bundled rate as well.

Original and 13 copies of the foregoing filed this 14th day of March, 2005, with:

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